IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A. D. 1941

No. 54

THE UNITED STATES OF AMERICA,
Petitioner,

vs.

JAMES M. RAGEN,
Respondent.

WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT, JAMES M. RAGEN.

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INDEX.

CITATIONS.

Cases:

PAGE

CITATIONS.

Cases (continued):

PAGE

CITATIONS.

Cases (continued):

Statutes:

Miscellaneous:

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QUESTIONS PRESENTED.

The principal question presented is the correctness of the conclusion of the Circuit Court of Appeals that the evidence is insufficient to support the verdict of guilty. This involves a consideration of the undisputed evidence offered by the Government including whether there was a failure to prove the charges alleged in the indictment and to support the theory upon which the case was tried by the Government in both courts below.

The evidence does not show that respondent,[1] Ragen, Sr., had any knowledge of or participated in any attempt to evade taxes of Consensus Publishing Company for any of the years charged in the substantive counts of the indictment and there is no evidence that he was connected in any way with a conspiracy to evade taxes as charged in the fifth count. The evidence fails to show that he had anything to do with or knew anything about the books of Consensus, its income tax returns, or its income tax matters, or that he knew of any conspiracy or agreement to evade its income taxes, if any such conspiracy existed.

The Government itself proved the falsity of the charge that the defendants had performed no services for Consensus. It was upon the theory that they had performed no services that the case was tried and argued in the lower courts. The hypothesis that the sums paid to defendants by Consensus might be found to be in excess of reasonable compensation for their services, and that to the extent of the excess paid and for which deductions were taken in its income tax returns, there was tax evasion, is not properly in issue under the indictment or the theory upon which the case was tried and argued below. That, moreover, was not a proper subject of inquiry by a jury since there is no sufficiently definite standard of guilt to meet constitutional requirements. It would also be necessary, in order to determine whether the compensation paid was unreasonable for evidence to be produced showing the total of the services rendered and the value thereof. The

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[1] Throughout this brief the word "respondent" is used to refer to James M. Ragen, Sr., respondent in Case 54. The term "Defendants" is used to refer to all the individual defendants convicted in the trial court and includes Arnold W. Kruse, Lester A. Kruse, and also William Molasky and James M. Ragen, Jr. The Government has not sought writs of certiorari to review the reversal of the convictions of Molasky and Ragen, Jr.

Government failed to offer such evidence. The issue would not be changed if the defendants were stockholders. Whether they were or not, the payments made could be held to be dividends only in the amount in excess of reasonable compensation for the services rendered. The court erred therefore in submitting any such question to the jury and in its charge to the jury.

As the Government urged below that the constitutional question was not involved in the case, and removed it as a controversial question by its argument that the payments either were all dividends or all commissions, the Government may not now shift its position and urge that the question is in the case.

STATEMENT.

Indictment. The indictment is in five counts (R. 2-27). The first four counts charge the defendants jointly with wilful attempts to defeat and evade income taxes of Consensus Publishing Company, a corporation (hereinafter sometimes referred to as "Consensus"), for the years 1933 to 1936, inclusive. The fifth count charges conspiracy to commit such an offense for the years 1929 to 1936, inclusive. There are questions connected with the construction of the charges made in the indictment which will be later considered in this brief.

Evidence. The Government's statement of facts is not and does not purport to be complete. Its brief (p. 4) states that it is a summary of the evidence "supporting the verdict of the jury." A fairer statement is contained in the opinion of the Circuit Court of Appeals (R. 497).

However, we find it necessary to give a more complete statement than will be found either in the Government's brief or the opinion of the Circuit Court of Appeals, in

view of our contention that a verdict should have been directed for this respondent.

Although the record is voluminous, the evidence is not conflicting. It consists only of the testimony of witnesses called by the Government, one of whom was examined as a court witness, and certain documentary evidence offered by the Government. The defendants offered no evidence.

Organization and business of the company. In September, 1929, at the suggestion of Moses L. Annenberg, who was one of the parties indicted but as to whom the indictment was dismissed, it was agreed that Moses L. Annenberg, Arnold W. Kruse, James M. Ragen, Sr., and William Molasky would take over and operate the business of printing and distributing a card known as a run-down sheet, which prior thereto had been distributed in St. Louis by Molasky and one Zweig (R. 319). At this meeting Annenberg said he would own the business and would be entitled to 30%, Molasky was to do the work at St. Louis, and was to be entitled to 30%, and Arnold W. Kruse and James M. Ragen, Sr. were to get 20% each for services to be rendered (R. 392, 416). Kruse and Ragen, Sr. then were employed by or associated with certain corporations in which Annenberg's Cecelia Investment Co. was interested (R. 392).

On September 18, 1929, an Illinois corporation known as the Consensus Publishing Company was organized. One hundred shares of its stock of the par value of $5,000 were subscribed for and issued as follows:

Howard Clark	20 shares
Thomas Ryan	20 shares
William Molasky	30 shares
Jules Taylor	30 shares (Ex. 67).

There is no evidence as to how this capital stock was paid for or by whom.

Payments of commissions by Consensus. From the time of its incorporation the earnings of Consensus were distributed weekly by checks as follows:

As *dividends*, 30% to Cecelia Investment Company which was a holding company for the stock of some seventy-five corporations owned by Annenberg, referred to sometimes as the Annenberg companies (R. 426-429);

As *commissions*, 30% to William Molasky, of which one-half or 15% was paid to B. Hoffman, in the years 1933 to 1936 (R. 426-429);

20% to Ragen, Sr. from October, 1929, until March 19, 1931 and 20% to Ragen, Jr. from April 3, 1931, through 1936 (R. 426-429);

20% to A. W. Kruse for the years 1929 up to and including August 4, 1932; 20% to Mrs. A. W. Kruse from August 11, 1932 to and including March 16, 1933; 20% to Lester A. Kruse from March 23, 1933 to and including 1936 (R. 426-429).

The books of account of Consensus were kept in the Chicago accounting office of the Annenberg Companies under the supervision of Arnold W. Kruse (R. 322, 323). Collections made by Molasky were deposited by him in the corporation's bank account in St. Louis (R. 323, 338). Every week he sent the Chicago office a statement of the collections and expenses and a check was issued to him each week for the previous week's expenses (R. 338, 411, W R Govt. Exhibits). Entries reflecting the above payments to defendants as "commissions" and to Cecelia as "dividends" were made in all of the books of account of the company (R. 328, 429). From 1929 and during the entire period, including 1937, in all of the income tax returns filed by the Company, deductions were taken from gross income for these commissions, under the item "Commissions" in the amounts specified in the indictment (R.

429). In some instances on work sheets prepared by one of the four bookkeepers for his own convenience in computation and making entries in the books and in weekly reports copied therefrom sent to the defendants the item "commissions" was called "dividends" (R. 334-338). The bookkeeper who made the work sheets testified the failure to add "and commissions" on his work sheets was neglect (R. 418). The other bookkeepers generally listed the commission payments under "commissions" on their work sheets (R. 337, 340, 348).

Services rendered by defendants. Prior to the organization of Consensus the business was confined to St. Louis. After its organization under the new management of the defendants the business spread to Cincinnati, Lexington, East St. Louis, Dayton, Columbus, Kansas City and other cities (R. 354, 365). Run-down sheets were printed in St. Louis and Cincinnati (R. 355). The principal business office was in Chicago. The books of Consensus were kept in another Chicago office, the Annenberg companies' accounting office, under the supervision of Arnold W. Kruse (R. 392). Molasky, Arnold W. Kruse, Ragen, Sr. and later Ragen, Jr. worked for the Company (R. 388, 387). Ragen, Sr. had his office in another place in Chicago (R. 385, 392). Molasky was in charge of the operations of the Company at St. Louis (R. 323, 354). Arnold W. Kruse and the two Ragens were consulted frequently by Molasky concerning business policies, and they, with Molasky, managed the operations of the Company (R. 385, 392). Molasky traveled extensively on the Company's business (R. 354, 355). In Molasky's absences, which were frequent, Arnold W. Kruse, Lester Kruse or one of the Ragens would be consulted by the St. Louis office for instructions and about customers and their orders (R. 354, 355). Ragen, Sr. was originally head of the General News Service which furnished news service to bookmakers (R.

392). Ragen, Jr. subsequently was in charge thereof (R. 394). Arnold W. Kruse was head of the Racing Form, a racing publication (R. 392). These concerns were Annenberg companies (R. 321, 392). Ragen, Sr., later Ragen, Jr., and Arnold W. Kruse were in a position to obtain run-down business from their customers. That they did so is shown by the fact that Brooks of St. Louis called upon them from time to time to assist in inducing Consensus' customers to restore orders for run-down sheets that had been reduced (R. 355). The run-down business had been unprofitable prior to the time of its operation by Consensus. Thereafter sales increased (R. 392), and the business, as shown by its income tax returns, became highly profitable (R. 21).

After Ragen and Arnold W. Kruse came into the business a number for each horse entered in races was put on the Consensus run-down sheets (R. 393). In transmitting news the General News Service used these numbers instead of the names of the horses, thereby correlating the News Service with Consensus run-down sheets. General News Service delivered the run-down sheets (R. 393).

The run-down sheet business, as conducted by Consensus, was not as simple as the Government's presentation would lead one to conclude. Much of the statement on this subject contained in the Government's brief is taken from Zweig's testimony. He relates circumstances connected with the operation of the business as conducted in St. Louis by him or by him and Molasky before the Consensus Company entered the business (R. 321). That testimony is not of much weight as to the operations of the business after his connection with it ceased. The remainder of the Government's statement on this subject is based upon Brooks' testimony. Brooks was familiar with the printing of the sheets in St. Louis, but knew nothing about the other operations of the business (R. 354-355). The indictment alleges (R. 21)

that Consensus was entitled to admitted deductions at the rate of approximately $40,000.00 per year for expenses during the period in question. These amounts are exclusive of the commission items. In addition, it appears that in some instances services were rendered to Consensus by employees such as Brooks, whose services were not charged as an expense to Consensus but to other enterprises conducted by some of the defendants (R. 352). This was probably true also regarding the expenses of maintaining the Chicago office of Consensus, as it appears from the evidence that the only deductions taken were those paid out by Molasky in St. Louis and remitted to him weekly (R. 323-324).

On this subject, the Circuit Court of Appeals in its opinion said (R. 700):

> "It does not require a great deal of proof to be convincing that the executives, managers, and employees of a corporation which earned a gross income of $119,960.96 for the year 1933 (in some years the income was much greater) rendered services and were reasonably entitled to substantial salaries. In 1929, Consensus took over a business—if it can be thus dignified—that was a losing proposition, and made it a financial success. So far as is disclosed by this record, these defendants alone were responsible for that success. According to the Government's theory, no executive ability was displayed and no service rendered for which the defendants were entitled to compensation or salary. Such a theory is incredible."

The indictment shows the Company paid substantial sums for salaries and wages each year (R. 5, 9, 12, 16). None of the witnesses who testified were paid any salaries by Consensus although many performed bookkeeping or legal services for it (R. 321, 339, 352, 357, 371, 421). It

is evident that various other persons worked for Consensus under the defendants, and otherwise came in contact with the defendants who could have testified as to the work the defendants did. Such witnesses were not called by the Government.

No attempt was made to show that the services testified to were the only services rendered by the individual defendants. There was no evidence offered as to the reasonable value of the services rendered by the individual defendants. No compensation for their services was paid except the commissions above mentioned.

History of stock certificates, corporate records, and employment contracts. For many years the minute-books and stock records of the seventy-five or more Annenberg companies had been neglected (R. 389). Minutes had not been written. Stock in these companies owned by the Cecelia Company, Annenberg's holding company, in many instances was outstanding in the names of dummies (R. 386, 387). In 1933 the corporate records were moved from New York to Chicago and Herbert Kamin, one of the parties indicted but dismissed before trial, who was an attorney, and whose wife was a relative of Annenberg, was employed to put the records in order and to take care of them, to bring the minutes up to date, prepare missing minutes, and see that stock outstanding in the names of others was put into the name of the Cecelia Company (R. 386-387). Kamin received instructions and information on this subject from Arnold W. Kruse (R. 371). Kamin commenced work on the Consensus records in the summer of 1934 (R. 390). No minutes for that Company had been drawn up since 1929. Its stock had been issued in the names of dummies (R. 387).

The original stock certificates had been issued in the names of the subscribers, in accordance with the Articles of Incorporation (R. 386). Transfers thereof had been

made, 30 shares from Taylor to the Cecelia Company in 1929; 15 shares from Molasky to B. Hoffman in 1933; 20 shares from Clark to Kamin in 1935. The certificate made in connection with the last mentioned transfer was delivered to Arnold W. Kruse (R. 375, 377).

In 1934 Arnold W. Kruse told Kamin of the meeting between M. L. Annenberg, Arnold W. Kruse, Ragen, Sr. and Molasky in 1929 and of the agreement then made that the Cecelia Company was to own all the stock of Consensus, and that Arnold W. Kruse, Ragen and Molasky were to get percentages of the profits as commissions for their services, that the stock of Consensus had been issued incorrectly, that Cecelia owned all the stock from the beginning, that the persons who held the stock were not the real owners but were incorrectly holding the stock, and that he wanted a new stock book showing such ownership, and requested Kamin to have the records reflect what had occurred, in a proper and legal manner (R. 374-375, 387-392).

In August, 1934, Kamin prepared a new stock book for Consensus, issuing new certificates to the four original subscribers and transferring them to one certificate for 100 shares in the name of Cecelia Company, all dated back to 1929, the time of incorporation (R. 377). Kamin sent the new certificates to Molasky to sign as President of the corporation and to endorse the certificate for 30 shares made out in Molasky's name as a subscriber and return them (R. 377, Ex. 200). Molasky did so (R. 377).

Some time later in 1934, Kamin prepared minutes of previous stockholders' and directors' meetings (R. 383) and in 1934, 1935, or 1936, prepared yearly employment contracts from 1930 (R. 378, 381, 382), the compensation specified in which corresponded with the commission pay-

ments theretofore paid the defendants as reflected by the books of the Company (R. 381, Ex. 82). Thereafter, employment contracts were made annually until 1938, which were authorized by the Board of Directors (R. 384, 393). In 1938 contracts with Molasky, Arnold W. Kruse and Ragen, Jr. for a ten-year period were executed and guaranteed by the Cecelia Company (R. 393, Ex. 102, 104, 106).

James M. Ragen, Sr. executed an assignment of the above employment contract for 1931 to his son, James M. Ragen, Jr. (Ex. 80, R. 381). Arnold W. Kruse executed an assignment of the above employment contract for 1932 to his son, Lester A. Kruse (Ex. 83, R. 382).

Kamin procured signatures for the minutes, employment contracts, assignments and new stock certificates (R. 379, 384, 398). The original stock certificates remained outstanding until 1938 (R. 384). Two stock books were in existence from 1934 to 1935 (R. 379). In 1938, after the ten-year employment contracts had been made, the original certificates were destroyed (R. 384, 385, 393). In 1934, a certificate for 100 shares of Consensus stock was issued to the Cecelia Company and some time thereafter was delivered to Annenberg (R. 377). The original certificate for 30 shares issued to the Cecelia Company was returned and cancelled. About a year after the new certificates were made out (R. 380), Kamin destroyed the original stock certificate book. Kamin drew new certificates, which were dated back, and minutes which were dated back, in some fifty corporations, in addition to similar work on Consensus (R. 396, 397).

There is no evidence that Ragen, Sr. ever owned or had in his possession any of the stock certificates issued by Consensus. There was received in evidence a sheet of paper dated October 28, 1929, captioned "Consensus Publishing

Company" (Ex. 29 C R 1, R. 333), which purported to be a list of officers and directors, on which the following appears:

"Stockholders (actual)	Number of Shares	Dummy
William Molasky	30	None
Cecelia Investment Co.	30	None
A. W. Kruse	20	Howard Clark
J. M. Ragen	20	Thomas Ryan

The paper bears no signature. It was among documents delivered to the Government under a grand jury subpoena issued to the Consensus Publishing Company. There is no evidence by whom, under whose direction or when the document was written.

Kamin received a Consensus certificate for 20 shares from Ragen, *Jr.* in 1938, which was then destroyed (R.385). Kamin did not look at the face of the certificate, did not know to whom it was issued, nor whether it was issued to Thomas Ryan. He never saw a certificate issued in the name of Ryan, having Ryan's endorsement, or in the name of Ragen, Sr. or his son. He had no knowledge of whether Ragen, Sr. was the owner of or held any stock. He only knew that Ragen, Jr. gave him a stock certificate in 1938 (R. 390). There is no evidence that any of the defendants paid anything for Consensus stock.

Income tax returns. The income tax returns of Consensus for 1929 to 1937, inclusive, were received in evidence (Exs. 1-9). In all of them the commission payments were deducted from gross income and the items thereof were specifically designated on the returns as commissions. The payments to the Cecelia Company were noted in the returns as dividends. None of these returns was signed by Ragen, Sr. (See Exs. 1-9). The income tax returns for 1931 and 1932 (Exs. 3 and 4) were audited

by the Bureau of Internal Revenue and additional taxes in small amounts were assessed in January, 1934, and January, 1935 (R. 316-318). Deductions for commissions do not appear to have been questioned in these audits.

The income tax returns of Ragen, Sr. for 1929 to 1937, inclusive, were received in evidence (Gov. Exs. 30-38). The items paid to him by Consensus Publishing Company were included in his personal income tax returns as commissions (Exs. 29, 30, 31). The individual income tax returns of other defendants were also introduced in evidence (Exs. 19 to 25, 26, 29, 27A, 39 to 44, 46 to 58). The other defendants to whom commissions were paid included them in their personal income tax returns as commissions, with the exception that Molasky reported them as dividends in his returns for 1933, 1934 and 1935 (Exs. 50, 51, 52).

Evidence showing connection of Ragen, Sr. with transactions disclosed by evidence.[2] We set forth below the only evidence connecting Ragen, Sr. with the transactions disclosed by the evidence.

Ragen, Sr. was present at the original meeting with Annenberg in 1929. Under the agreement then made, he was to receive 20% of the net earnings of the run-down sheet business (R. 416). He received this amount weekly until March 19, 1931 (R. 426). Thereafter his son, Ragen, Jr., who was connected with the business of General News Bureau (R. 426), received the like percentage, and Ragen, Sr. received nothing further from the above source (R. 426).

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[2] It is to be noted that this brief is filed only on behalf of James M. Ragen, who is sometimes referred to as James M. Ragen, Sr. His son, James M. Ragen, Jr., also was a defendant. He was convicted and fined. His conviction was reversed by the Circuit Court of Appeals and the Government has not sought to review that judgment of reversal.

There is nothing to show that Ragen, Sr. was a stockholder of Consensus, paid anything for stock of that corporation, or ever had any stock certificate thereof in his possession, or knew that he was entitled to any stock thereof, except for the unauthenticated Exhibit 29 C R 1 (R. 333), and whatever inference may be drawn from the circumstance that in 1938 his son, Ragen, Jr., was in possession of a stock certificate of Consensus as hereinabove recited. (The above Exhibit 29C R1 has no evidentiary value *Nicola* v. *U. S.* (C.C.A. 3) 72 F. (2d) 780, 782.) There is nothing to show that Ragen, Sr. knew anything about the destruction of the original stock book or stock certificates of Consensus or the writing of new certificates for stock of that Company.

While the copies of the bookkeeper's work sheets which were sent to Ragen, Sr. listed the commission items under "dividends" (R. 338), the books of Consensus showed the amounts paid to him as commissions. He returned the items paid to him as commissions in his personal income tax returns, thus paying a greater personal income tax thereon than if he had returned them as dividends.[3]

Ragen, Sr. rendered services as above shown to Consensus during the period he received these commissions. The Government, on page 12 of its brief, refers to the testimony of Burris to show that Ragen, Sr. did no work for Consensus. Burris, however, was not in the employ of any of the Annenberg companies until 1933 (R. 339), which was long after the date when Ragen, Sr. ceased to receive commissions from Consensus. The witnesses called by the Government other than Brooks, had nothing to do

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[3] Prior to the effective date of the Revenue Act of 1936, dividends paid to an individual were not subject to normal taxes but only to surtaxes. Commissions were subject to both normal and surtaxes. See Revenue Act of 1934, 48 Stat. 680, C. 277 § 25(a)(1).

with the operations of Consensus during the period for which Ragen, Sr. received commissions (R. 322, 339, 347, 357, 371, 411). The Government refers to the testimony of Brooks as disproving the rendition of services by Ragen, Sr. Brooks, however, worked only at the St. Louis office (R. 50). Ragen's office was in Chicago (R. 392). Brooks would not be in a position to know what services Ragen, Sr. performed in Chicago. Brooks did testify, however, that he had talked to Ragen, Sr. on the telephone regarding the business and policies of Consensus at various times (R. 355). None of the other witnesses gave evidence as to the character or extent of the services of Ragen, Sr.

Ragen, Sr. was never an officer or director of Consensus. He signed no contracts, except the employment contracts in which he was named as an employee for the years 1930 and 1931, and the assignment of the 1931 contract to his son. These were prepared by Kamin, attorney for the company, and handed to Ragen, Sr. for signature. Ragen, Sr. did not sign any minutes of any meeting of stockholders or directors. He did not attend any stockholders' meeting. He did not execute a proxy for any stockholders' meeting.

While the Government contends that Arnold W. Kruse instructed Kamin to prepare written employment contracts, to obtain the signatures of the parties thereto, and to draw up new stock certificates, after learning about some Board of Tax Appeals decision, there is no evidence that Ragen, Sr. knew anything about that decision or that the signing of the written employment contracts had any connection with income taxes. He was asked to sign them by Kamin and did so. So far as Ragen, Sr. was concerned the employment contracts merely reflected what had actually happened. He understood he was to receive 20% of the net earnings for his services from the time of the taking over of the run-down sheet business in 1929 until March 19, 1931, when he ceased to have any

further interest in the matter. He had received those payments and had filed his personal income tax returns including them in a manner making them fully taxable to himself. There was no reason for his not acceding to the request of his employer's lawyer to sign them and he did so.

No income tax return of Consensus was signed or filed by Ragen, Sr. (Ex. 1-9). He was not consulted in regard to the preparation of any such return. There is nothing to show that he knew the contents of any of those returns or the basis upon which they were made.

SUMMARY OF ARGUMENT.

I.

The evidence is insufficient to support the verdict of guilty against Ragen, Sr. There was no evidence connecting him with any of the charges in the first four counts of the indictment alleging that defendants wilfully attempted to evade income taxes imposed upon Consensus for the years 1933 to 1936 by filing tax returns claiming deductions for commissions in those years. He had ceased to receive commission payments in March, 1931. He had nothing to do with the preparation or filing of any of the income tax returns in question, did not know the contents thereof or the deductions taken therein. A verdict should therefore have been directed for Ragen upon the first four counts.

As to him the evidence was also insufficient to sustain the verdict upon the fifth count of the indictment and a verdict of not guilty under that count should have been directed, for the following reasons:

(a) Commissions or percentages of net profits or earnings of a corporation may be paid by it for services rendered, and to the extent that they are reasonable in amount are deductible in computing taxable income. It appears from the evidence that the commissions were paid as compensation for services rendered. It is unimportant whether the defendants to whom the commissions were paid were stockholders or not. In either event, they were entitled to compensation for their services, and to the extent such compensation was reasonable it could properly be deducted.

(b) The fifth count charged that the defendants did not in fact render services to Consensus and consequently the deductions therefor in its income tax returns were unlawful. The evidence shows services were rendered. There was therefore a failure to prove the charge.

(c) If the reasonableness of the compensation paid was an issue, the evidence was insufficient to warrant the submission of that question to a jury, because there was no showing as to the total of the services rendered by the defendants or as to the reasonable value of their services.

(d) The evidence discloses an arrangement entered into for the payment to the defendants of a part of the earnings of Consensus as compensation for services. The arrangement made had nothing to do with either the tax liability of Consensus or of the defendants. Subsequently, the amounts paid to the defendants were taken by Consensus as deductions in its income tax returns. There is no evidence that Ragen, Sr. had anything to do with those returns or knew their contents or knew of the deductions taken. There is an entire absence of evidence that anything that Ragen, Sr. did was done in bad faith with intent to defeat or evade a tax against Consensus or pursuant to a conspiracy entered into for that purpose. There is no showing that Ragen, Sr. had any knowledge of the existence of any conspiracy, if the evidence proved there was such a conspiracy. There can be no conviction of one as a conspirator in the absence of knowledge on his part of the conspiracy, even though he may have performed some act which furthered the object of the conspiracy.

II.

The Government should not be permitted to shift its position as to whether the case presents the question of there being a sufficiently definite standard of guilt for a

jury to convict. The Government, in the Circuit Court of Appeals, urged that the deductions must be treated either as dividends in their entirety or as commissions in their entirety. This removed the constitutional question from the case. It was not brought back into the case by the Circuit Court of Appeals mentioning it as one alternative reason for its conclusion that the judgments should be reversed.

III.

If, however the constitutional question is properly before the Court, we submit the due process clause of the Fifth Amendment and the provision of the Sixth Amendment that in all criminal prosecutions the accused shall enjoy the right to be informed of the nature and cause of the accusation require that a definite, ascertainable standard for determining guilt be prescribed by statute or regulation. There is no such standard, where a conviction may rest upon the judgment of a jury as to the reasonableness of compensation paid for services rendered.

IV.

The Government failed to prove the charge made in the indictment that no services were rendered. The Government's theory of the case below was that no such services were rendered. Its evidence was to the contrary. In the absence of evidence as to the total of the services performed and the reasonable value thereof, there was no foundation for any other contention.

A portion of the charge of the Court was properly held to be erroneous by the Circuit Court of Appeals because it was inconsistent with the indictment and the theory upon which the case was tried, and because it left the jury at liberty to speculate and conjecture, without evi-

dence on the subject whether any portion of the items paid was dividends as distinguished from compensation for services rendered.

The sufficiency of the exception to the charge is challenged by the Government but that challenge is not meritorious under the authorities. The exception was sufficient. In any event, error in the charge in criminal cases may be noticed, although not properly raised by exception.

ARGUMENT.

I.

The Circuit Court of Appeals correctly held that the evidence was insufficient to support a verdict of guilty.

While the Government contends that the Circuit Court of Appeals did not expressly rule that the evidence was insufficient to support a guilty verdict, it admits that the "plain inference" of the opinion is that the Court reversed upon that ground (Gov. Br. 18). We do not believe any other conclusion can be drawn from the opinion.

The sufficiency of the evidence is the important question in the case, although the Government treats it rather summarily in its brief (pp. 17-22). The question as to whether there is a sufficiently definite standard of guilt to comply with the requirements of the Fifth and Sixth Amendments to the Constitution becomes important only after a determination that there was adequate evidence to authorize submission of the cause to a jury. The constitutional question was only one alternative question considered by the Circuit Court of Appeals in reversing (R. 502). The Government, in its brief and in its oral argument before the Circuit Court of Appeals, avoided a presentation of its views upon that question by conceding that the deductions taken in the Consensus tax returns should be treated either as dividends in their entirety or as commissions in their entirety. (See opinion of the Circuit Court of Appeals, (R. 502), and discussion on pp. 40-45 of this brief.)

We have set forth in our Statement (pp. 13-16) all of the evidence relied upon to connect Ragen, Sr. with the alleged tax evasion or the alleged conspiracy to effect it. That evidence, we submit is insufficient to support a guilty verdict against him and the trial Court therefore should have directed a verdict in his favor.

A. The evidence is insufficient to sustain a guilty verdict against Ragen, Sr. upon the first four counts of the indictment.

The first four counts of the indictment (R. 2, 7, 11, 14, allege that defendants wilfully and knowingly attempted to evade and defeat a large part of the taxes imposed upon Consensus for the years 1933, 1934, 1935 and 1936, and such attempt was made by preparing and filing and causing to be prepared, sworn to and filed, income tax returns for that corporation for those years, claiming deductions for "commissions" in certain specified amounts for each of the years.

It will be noted that the years covered in these counts are 1933, 1934, 1935 and 1936. Ragen, Sr. ceased to receive commission payments upon March 19, 1931 (R. 426). He never was an officer or director of Consensus. He had nothing to do with its books, neither prepared, signed nor filed any income tax return of Consensus (Exs. 1-9), nor aided, abetted or assisted in the preparation or filing thereof, nor knew the contents thereof, nor the deductions taken therein.

The employment contracts which Ragen, Sr. did sign were employment contracts for the years 1930 and 1931 and the assignment which he executed to his son was of the 1931 employment contract (R. 381). None of these could have any connection with an attempt to evade or defeat taxes of the Consensus for the years 1933 to 1936.

Under such circumstances, it is difficult to see upon what theory Ragen, Sr. could be held to have attempted to evade or defeat any of the taxes upon Consensus for those years, by means of preparing and filing, or causing to be prepared, sworn to or filed income tax returns for that corporation for any of those years, as charged in those counts. A verdict of not guilty as to him upon those counts should have been directed. The judgment against him must stand or fall upon the sufficiency of the evidence to prove the fifth or conspiracy count.

B. The evidence is insufficient to sustain the verdict against Ragen, Sr., upon the fifth count of the indictment.

The substance of the fifth count of the indictment is that the defendants conspired to evade and defeat the payment of a large part of the income taxes imposed upon the Consensus Publishing Company for the years 1929 to 1936 inclusive, that the individual defendants in order to deceive officers and employees of the Government and to prepare the way for the making of false and fraudulent returns and for failing to pay true and correct taxes on the net income of the corporation, would dominate and control the corporation, and in each of the calendar years from 1929 to 1936 inclusive, caused the corporation to enter into certain employment contracts by the terms of which the corporation engaged the services of certain of the defendants in an executive capacity and agreed to pay them large percentages of the net profits of the corporation as commissions, wages and salaries; that pursuant to the conspiracy percentages of profits were paid to the defendants as they accrued at the end of each and every week during the contracts in accordance with the contracts, that the defendants would cause entries to be made upon the books of the corporation by virtue of which it was made to appear that such sums were paid as commissions and

salaries for services rendered, and that said sums would be fraudulently and falsely claimed and deducted as proper deductions from the gross income of the corporation. The sums paid under the employment contracts are set forth, and it is alleged that the defendants would not in fact be nor were they employed in any capacity whatsoever by the corporation by virtue of the contracts, nor did they or any of them nor anyone else for them render any services to the corporation by virtue of the contracts, but that in fact they were owners of beneficial interests in the corporation for themselves and others, and the monies paid to them by virtue of the employment contracts were in fact distributions of profits and dividends from the earnings of the corporation and taxable to it as net income, and the employment contracts, books, records and accounts reflecting the employment and the payments made thereunder were mere shams to evade payment of income taxes due from the corporation. It further alleged the filing of income tax returns claiming the commission items as deductions from gross income and various overt acts which were alleged to have been done in pursuance of the conspiracy (R. 18-27).

We submit that a verdict of not guilty as to the fifth count should have been directed for Ragen, Sr. on the following grounds:

(1) Commissions or percentages of net profits of a corporation paid for services rendered are deductible in computing taxable income.

(2) It is charged in the fifth count that the defendants did not, in fact, render any services to Consensus, and consequently the deductions therefor were unlawful. The evidence shows services were rendered. There was, therefore, a failure to prove the offense alleged in the count.

(3) If the reasonableness of the compensation paid to defendants was an issue in the case, the evidence was

insufficient to warrant the submission of that question to a jury, because (a) there was no showing that the services shown to have been rendered were all of the services rendered by defendants, and (b) there was no evidence of the reasonable value of the services rendered.

(4) There was a failure to prove that Ragen, Sr. was an original party to any conspiracy to evade taxes upon Consensus, or that knowing of any such conspiracy, he afterwards became a party thereto. Knowledge of the conspiracy is essential to charge one as a conspirator notwithstanding he may have performed some act which furthered the object of the conspiracy.

(5) There is no evidence Ragen had any intention to defeat or evade income taxes against Consensus, wilfully and in bad faith and with evil intent.

We submit the evidence discloses a business arrangement entered into by Ragen, Sr. in 1929 for the payment to him of a part of the profits of Consensus as compensation for his services. The arrangement so made had nothing to do with either Consensus' tax liability or his own. Subsequently the amounts so paid to him and to others were taken by Consensus as deductions in its income tax returns. There is no evidence that he had anything to do with those returns, or knew their contents or of the taking of the deductions or of the intention to do so. There is an entire absence of evidence that anything that Ragen, Sr. did was done in bad faith, with intent to attempt to defeat or evade a tax against Consensus, or was done pursuant to a conspiracy of which he had knowledge entered into for that purpose.

(1) *Commissions or percentages of net profits of a corporation paid for services rendered are deductible in computing taxable income.*

It is well established that commissions or percentages of the net profits or earnings of a corporation may be

paid by it for services rendered and may properly be deducted in computing its net taxable income under the applicable Revenue Acts and the Regulations made thereunder. Section 23(a), Revenue Act of 1932, 26 U. S. C. A. Section 23(a), quoted at page 36 of petitioner's brief, and Sections 23(a) of the Revenue Acts of 1928, 1934 and 1936, which are identical; Treasury Regulations 74, Article 126, promulgated under the Revenue Act of 1928, quoted in the appendix to this brief, and Article 126 of Regulations 77, and Article 23 (a)-6 of Regulations 86 and 94, promulgated under the Revenue Acts of 1932, 1934 and 1936, respectively, all of which articles are substantially identical; *William S. Gray & Co.* v. *United States*, 35 F. (2d) 968, 974 (Court of Claims); *Austin* v. *United States*, 28 F. (2d) 677-678 (C. C. A. 5th).

In *William S. Gray & Co.* v. *United States*, it was held that contingent compensation of $699,645 in addition to fixed salaries of $160,000 paid during three years to certain executives and directors who were also stockholders owning 88% of the capital stock of the corporation, amounting to all of the corporation's earnings after a 7% dividend, was deductible by the corporation.

In the *Austin case*, sums paid for services under a contract providing for the payment of all of the corporation's net profits as compensation for services were held to be deductible. In one year this sum was approximately $168,000.

There is controversy on the question whether the evidence shows that the individual defendants were stockholders of Consensus. We believe the evidence does not establish that Ragen, Sr. was a stockholder. The evidence on this subject is set forth on page 14 of this brief. His stock ownership does not appear of record, there is no showing that he paid anything for the stock, and the affirmative evidence establishes that it was the intention

that Cecelia Company should be the owner of all of Consensus' stock and that certainly was finally accomplished (R. 374, 387, 416). No dividend was declared by Consensus, and none was ever paid by it except to Cecelia Company (R. 327, 328, 360, 361, 412).

However, whether or not the defendants were stockholders is not of controlling importance. Persons who perform services for a corporation are entitled to receive compensation therefor, even though they are stockholders, and the corporation is entitled to deduct a reasonable allowance for compensation paid for such services, even though the recipients are stockholders. The evidence shows that the defendants rendered services to Consensus. The evidence fails to show that the services disclosed were all the services performed by them for the Company. There is thus no evidence as to the quantum of services rendered by the defendants. Moreover, there is no evidence as to the reasonable value of the services rendered by the defendants. Upon such a record it cannot be said that the sums deducted for commissions paid to the defendants were in excess of a reasonable allowance of compensation for services rendered by them. There is thus no showing that tax evasion in point of fact occurred or was attempted.

(2) *The fifth count charges that no services were rendered by defendants to Consensus. The evidence shows that services were rendered by them. A verdict should have been directed, because the charge was not proved as alleged.*

The substance of the fifth count of the indictment (R. 18-27), summarized above is that the individual defendants, having control of Consensus, conspired to cause it to pay commissions to them for their services in an executive capacity, intending that no services were to be performed by them, and that the amounts paid as commissions, though in fact distributions of earnings and profits, were to be

and were deducted in its income tax returns as commissions for services rendered, and that no services were performed by the defendants.

The Circuit Court of Appeals decided (R. 502) that the conspiracy count of the indictment directly alleged that none of the defendants rendered any services to Consensus. The Government urges (Govt. Brief pp. 31, 17, 18, 3) that the Court misread the fifth count. It contends that the fifth count does not allege that no services were performed by the defendants but only that no services were performed by virtue of the so-called employment contracts, and that it charged that the employment contracts, which had been dated back, were spurious.

This construction, presented by the Government for the first time in its brief in this Court, is a rather belated one. The Government did not so construe this count in its petition for certiorari. There, in Footnote 9 on page 15, it is said:

> "Count 5 of the indictment, it is true, alleges that none of the defendants performed any services for Consensus (R. 23), while the proof showed that some of the defendants did perform services."

It is evident from the opinion of the Circuit Court of Appeals (R. 502) that the Government did not argue for any such construction of that count before that Court.

Actually, the fifth count contains no allegation that the employment contracts were spurious because of their being antedated. The charge was that they were shams because services were not intended to be and were not rendered and the distributions, in fact, were dividends (R. 23). The draftsman of that count evidently regarded the employment contracts as executed on the dates they bear, because it is alleged (R. 22) that the persons charged in the in-

-dictment "in each of said calendar years 1929 to 1936" caused the corporation to enter into the so-called employment contracts. The count, in stating the overt acts committed (R. 25-27), alleges the signing of the employment contracts on the respective dates they bear and not on the dates, some years later, when they were actually executed. It also charges (R. 22) that the weekly payments to defendants were made in accordance with the employment contracts, and the amounts alleged to have been so paid in each year, including the years before the employment contracts were signed, are the amounts which were actually paid in each year as "commissions."

Further on in the same count (R. 23) it is alleged that "the defendants were not employed in an executive capacity or in any capacity whatsoever by virtue of the employment contracts, nor did they render services by virtue of them, but that they were owners and holders of beneficial interests for themselves and others in the corporation, and all of the moneys paid to them by virtue of the employment contracts were distributions of profits and dividends from earnings of the corporation."

It is evident that the indictment was intended by the pleader to charge that the weekly payments made to each of the defendants receiving commissions through the period covered by the indictment were received by them as "distributions of profits and dividends from the earnings of the corporation" (R. 23) and were not paid to them for services rendered to Consensus, and that they did not render services to Consensus in an executive or in any other capacity.

If the fifth count should be given the construction for which the Government now contends, its averments would be insufficient. There would be no averment denying that defendants had performed services for Consensus other-

wise than under the employment contracts. For any such services they would have been entitled to compensation which could properly be deducted. The count would contain no denial that the deductions taken in the return for commissions were not properly allowable to Consensus as compensation for services rendered otherwise than under the employment contracts.

The Circuit Court of Appeals rightly concluded that the fifth count charged that no services were rendered by any defendant to Consensus and that the evidence disproved that allegation with respect to all defendants. We have set out in this brief (pp. 6-9) the services rendered by the defendants disproving the charge that no services were rendered by them.

(3) *There was no showing as to the total of all services rendered by the defendants to Consensus or the reasonable value of those services. Even if the question of the reasonableness of the compensation were an issue in the case, a verdict should have been directed, because the evidence was insufficient to warrant the submission of that question to a jury.*

The Government, in its brief (p. 22) asserts that evasion of the entire amount charged is not required to be proved. We do not question the correctness of that statement as an abstract proposition of law. However, the Government is required to prove evasion of some part of the tax by competent evidence. The jury cannot indulge in speculation or conjecture unsupported by evidence.

It was incumbent upon the Government to introduce evidence as to the total of the services performed by defendants for Consensus and the reasonable value of those services, if it intended to raise the question that part of the payments made to the defendants were in excess of reason-

able compensation and thus not deductible in ascertaining the net income of Consensus.[4]

If it was intended to be urged that the payments constituted unreasonable compensation, evidence should have been introduced as to the time spent by defendants, the nature and extent of the services rendered by them, the value of the results accomplished, their aptitude for the work, and the amount of compensation which would be reasonable for the services shown to have been rendered. Those matters, as well as the circumstances existing at the time the arrangement was made for compensation, were necessary to enable the jury intelligently to pass upon the question of the reasonableness of the compensation paid. In 1929, when the agreement to pay commissions was made, the business was unprofitable, and the expected profits of Consensus were speculative. "The circumstances to be taken into consideration are those existing at the date the contract for services was made, not those existing at the time when the contract is questioned." (Treasury Regulations set forth in the Appendix.) The Circuit Court of Appeals on this subject said (R. 500):

> "There was no proof and no effort by the Government to show that the services disclosed constituted the total of those performed and no effort to show the reasonable value of such services."

The deductions for commissions could have been improper only upon one of two hypotheses: either (a) the deductions were improper in their entirety because the defendants rendered no services, or (b) the deductions

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[4] In the Circuit Court of Appeals, the Government took the position that the payments to the defendants should be considered either as dividends or as commissions in their entirety; that there was no middle ground. See opinion of the Circuit Court of Appeals (R. 502) and argument under Point II of this brief upon this question.

were improper in part because in excess of reasonable compensation for services rendered. The Government chose to present its case upon the first alternative, but its evidence did not prove it. There was no attempt by the Government to introduce evidence to make out a case under the second alternative, and there was no evidence upon which the case could have been submitted to the jury upon that hypothesis. Any verdict upon that hypothesis could rest only upon speculation and conjecture.

(4) *Knowledge of the conspiracy is essential in order to charge one as a party thereto, notwithstanding he may have done some act in furtherance of the object of the conspiracy.*

In *United States* v. *Falcone*, 311 U. S. 205, 210, the Court held that the gist of the offense of conspiracy "is agreement among the conspirators to commit an offense, attended by an act of one or more of the conspirators to effect the object of the conspiracy," and that "those having no knowledge of the conspiracy are not conspirators," even though acts done by them may have furthered the object of the conspirators. We shall argue the application of this ruling to Ragen, Sr. under subheading (6) of this point.

(5) *In a prosecution for a wilful attempt to defeat and evade taxes it is not sufficient to show merely that a lesser tax was paid than was due. It is essential to prove that the acts complained of were wilfully done in bad faith and with evil intent to defeat and evade the tax.*

In a prosecution such as this, an essential element of the crime which must be established, is that the acts complained of were done wilfully, in bad faith and with evil intent; it is insufficient to establish merely that the acts were done intentionally without legal justification, and that less tax was paid than was due. (*United States* v. *Murdock*, 290 U. S. 389, 397.) Indeed the Government's Brief (p. 16) recognizes this to be the law. Under subheading (6) we

shall discuss the application of this rule of law to the evidence in the case pertaining to Ragen, Sr.

(6) *The evidence does not show that Ragen, Sr. had any knowledge of the alleged conspiracy and does not show that he did any act in bad faith or with evil intent in an attempt to evade or defeat payment of Consensus' income taxes.*

The authorities cited under subheading (1) above establish that there was nothing inherently wrong with an arrangement for the payment of commissions to defendants for services rendered to Consensus, and that to the extent such payments were reasonable, they were deductible in computing net taxable income under the applicable Revenue Acts.

No inference can be derived from the evidence concerning the agreement made in 1929 during the conference at which Annenberg, Molasky, Arnold W. Kruse and Ragen, Sr. were present (R. 419), other than that a business deal was then agreed upon which was for the mutual benefit of all parties concerned. Nothing was said or done at that meeting indicating that the parties had any question of tax liability under consideration, or that any of them had any other motive or intention in mind than that of collecting for their own benefit the sums agreed to be paid to them. Consensus was not then in existence. In fact, there was nothing said at that meeting about the organization of a corporation. There was nothing said as to how income tax returns of the business should be made up or whether income tax deductions should or should not be taken for the payments to be made to Molasky, Kruse and Ragen, Sr. The evidence shows that the arrangement then made, afterwards confirmed by the written employment contracts, was carried out. It is not shown that Ragen, Sr., was ever consulted with regard to the preparation of any income tax return of Consensus or the deductibility by it of the commission items, or had

anything to do with the signing or filing of its tax returns, or knew what any of those returns contained. He was not an officer or director of Consensus. It is shown (Ex. 30, 31, 32) that Ragen, Sr., in his personal income tax returns, included the commissions received by him as compensation for services, paying normal taxes and surtaxes thereon, although, if the amounts had been considered by him in his returns as dividends, he would have had to pay surtaxes only thereon.

The Government contends that in 1934 the question of the deductibility of the commission payments under a Board of Tax Appeals decision was discussed (R. 393). This discussion took place between Kruse and Kamin. In 1931, Ragen, Sr. had ceased to be a recipient of commissions (R. 426). There is nothing to indicate that the question of the deductibility of the commissions was ever discussed with him or that he knew anything regarding that question. He was asked by Kamin, his employer's lawyer (R. 381), some time between 1934 and 1936 to sign the written employment contracts evidencing his employment for the years 1930 and 1931 by Consensus and the assignment of his contract of employment to his son. There was no reason why he should not do this, as the written contracts merely evidenced his understanding of what had already occcurred, and they were in accordance with the agreement that he had made concerning receiving commissions. There is nothing to show that Ragen, Sr. knew that the execution of any of these papers had any connection with any plan, if there was one, to evade income taxes of Consensus or with any issue of tax liability of that company. There was nothing to indicate to him that any conspiracy existed, if one did exist, to attempt to evade or defeat any part of the tax liability of Consensus. Having no knowledge of the conspiracy, under the *Falcone* case, 311 U. S. 205, 210, Ragen, Sr. was not a conspirator, even though his acts in signing

employment contracts and the assignment of one of them to his son may be claimed to have furthered the object of the alleged conspiracy.

In *Dahly* v. *U. S.*, (C. C. A. 8) 50 F. (2d) 37, 43, the court said:

> "Even participation in the offense which is the object of the conspiracy does not necessarily prove the participant guilty of conspiracy. The evidence must convince that the defendants did something other than participate in the offense which is the object of the conspiracy. There must, in addition, thereto, be proof of the unlawful agreement and participation therein, with knowledge of the agreement."

Davidson v. *U. S.*, (C. C. A. 8), 61 F. (2d) 250, 253 and *Weniger* v. *U. S.*, (C. C. A. 9), 47 F. (2d) 692, 693, are to the same effect.

Here there is entire absence of evidence of the unlawful agreement, or of participation therein by Ragen, Sr. with knowledge of the unlawful agreement.

On Page 18 of its brief, the Government says that the opinion of the Circuit Court of Appeals "undertakes to cast a balance between the *conflicting inferences*," and on page 20 refers to "persuasive inferences" that might be drawn from certain evidence, and on page 21 argues that all conflicts should be resolved against respondents.

The *evidence* in the case was not conflicting. It was that of the Government alone. If "conflicting *inferences*" can be drawn from undisputed evidence so that every hypothesis except that of guilt is not excluded, the accused is entitled to a directed verdict.

In *Nicola* v. *United States*, 72 F. (2d) 780, 786 (C. C. A. 3), in a prosecution for tax evasion, the Court said:

> "Unless there is substantial evidence of facts which exclude every other hypothesis but that of guilt, it is the duty of the trial court to instruct the

> jury to return a verdict for the accused; and where all the substantial evidence is as consistent with innocence as with guilt, it is the duty of the Appellate Court to reverse a judgment of conviction."

In *Tingle* v. *United States* (C. C. A. 8), 28 F. (2d) 573, 575, it was said:

> "Circumstances merely arousing suspicion of guilt are insufficient. It must be remembered that appellant introduced no witnesses. *The evidence was not conflicting and was that of the government alone. In such case, when the circumstances relied upon are as consistent with innocence as with guilt, they are robbed of all probative value.*" (Italics supplied.)[1]

In a footnote on page 21 of its brief, the Government cites *Gurzik* v. *U. S.* (C. C. A. 7), 54 F. (2d) 618 to support the assertion that the accused cannot fairly ask a reviewing court to assume that prejudicial facts which had been proved and were unexplained could have been overcome on some hypothesis, had the accused testified. But in that case there was direct evidence that the accused had received large sums of money as income from his business which were not reported in his income tax return. That case has no application here. In the *Gurzik* case, the Court threw upon the accused the burden of explaining away *evidence of* guilt. Here a record is being reviewed which contains no evidence of guilt. The Court is asked to infer guilt, because of failure to testify. No such inference legally can be drawn.

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[1] To the same effect are *Kasun* v. *U. S.* (C. C. A. 5), 87 F. (2d) 183, 184; *Paddock* v. *U. S.* (C. C. A. 9), 79 F. (2d) 872, 876; *Truehen* v. *U. S.* (C. C. A. 10), 93 F. (2d) 861, 867; *Ridenour* v. *U. S.* (C. C. A. 3), 14 F. (2d) 888, 892; *Nemowitz* v. *U. S.* (C. C. A. 2), 282 F. 575, 578; *Hendrix* v. *U. S.* (C. C. A. 6), 233 F. 5, 18; *Langer* v. *U. S.* (C. C. A. 8), 76 F. (2d) 817, 827; and *Davidson* v. *U. S.* (C. C. A. 8), 61 F. (2d) 250, 253.

The entire absence of bad faith and of intent to evade or defeat any tax upon Consensus by taking the deductions for commissions is shown by the circumstances that each of the income tax returns for Consensus for the years 1929 to 1936 claimed deductions for commissions, and a schedule was attached to each return in which the item of commissions as a deduction appeared. The following schedule for the year 1934 (Ex. 6) is typical of the other years:

Gross Income		$129,665.78
Deductions		
Rent	$ 650.00	
Interest	347.82	
Taxes	293.00	
Depreciation	1,214.00	
Salaries and Wages	12,708.56	
Commissions	*60,172.23*	
Delivery	4,420.00	
Elec. & Gas	139.45	
Exchange	155.76	
Express & Postage	3,891.59	
General Expense	674.06	
Insurance	143.86	
Mechanical Supplies	162.76	
Office Supplies	1,785.00	
Paper & Cards used	2,069.17	
Printing	5,200.00	
Service	5,100.00	
Stationery & Printing	53.30	
Tele. & Tele.	413.17	
Traveling Expense	655.00	
Checks, N. S. F.	151.34	
Total deductions		100,400.07
Net income		$ 29,265.71

The returns of Consensus for the years 1931 and 1932 were audited by officers of the Internal Revenue Service. Additional taxes of $24.60 for one year and $96.10 for another year were assessed and paid. The deduction for commissions does not appear to have been questioned (R. 316).

In determining the issue of whether these deductions were taken in bad faith, it is to be remembered that until the Revenue Act of 1936 compensation for services received by individuals was subject to normal taxes and surtaxes, whereas dividends were subject only to surtaxes until that year. Because of this, the Government received more in normal taxes from the defendants than would have been payable if the amounts had been treated as dividends in the defendants' income tax returns. If Consensus had paid taxes on its income without deductions for commissions, the individuals would have received lesser sums for commissions. Therefore, less in individual surtaxes would have been paid by them.

It is not to be overlooked that the alleged conspiracy is said to have been hatched in 1929. Tax rates were much less then than they were in later years. Under conditions existing in 1929, and under the low tax rates then prevailing, the total tax savings to be gained as a result of the alleged conspiracy would have been trifling. The amount of the prospective profits of Consensus and of the corporate taxes thereon were speculative at that time. The business theretofore had been unprofitable. These circumstances should dispel any inference of the existence of a motive on the part of the defendants to evade income taxes. There is no evidence of an agreement or an arrangement made at that or at any other time, of which Ragen, Sr. had knowledge regarding the method to be used in reporting the payments made to the defendants on the income tax returns of Consensus.

There is evidence that reports made by the bookkeepers accompanied the weekly checks to Ragen, Sr., in which the distributions were designated as dividends (R. 334). The Government attaches significance to this, as indicating that the recipient knew that the items were dividends and not commissions (Gov. Br. 9, 20). But so far as Ragen, Sr. is concerned, if such knowledge is to be imputed to him, did he not also have the right to assume that the items were shown also as dividends on the books of the company and that the tax returns of the company would be made by those charged with that duty on the same basis?

In *Austin* v. *United States*, 28 F. (2d) 677, one of the questions which was considered was whether in a case where the entire net profits of the business had been paid out in salaries and taken as deductions in computing taxes there had been any intention to evade payment of taxes. The language used by the Court is so apt in its application to the present case that we make the following quotation from it (p. 678):

> "We agree with the District Judge that the evidence does not disclose any intention on the part of the stockholders to take advantage of their corporation, or to evade payment of income and excess profit taxes. Austin and Snook owned all the stock of the coal company, and it made little difference to them whether they received the profits as salaries or as dividends. They paid income taxes on their salaries, and there would have been little if any, difference if the corporation had itself paid the taxes and distributed the profits to them as dividends. There was no effort at concealment by the corporation, which included in its income returns the statement that it had paid out its entire net profits as salaries. Nor was there any effort at evasion by the stockholders, who included the salaries they had received. With full knowledge, the government ac-

> cepted the income taxes upon the salaries. Though the fact that these payments were collected and are yet retained affords no defense to this suit, it does remove from the case any element of bad faith."

The circumstances which the Court in the *Austin* case said removed any element of bad faith from the case are present here. Consequently, we submit that the evidence does not show any bad faith, or attempt to evade or defeat taxes, and therefore, following the doctrine of the *Murdock* case, 290 U. S. 389, 397, a verdict for the defendants should have been directed.

II.

The question as to whether there is a sufficiently definite standard of guilt for the jury to convict, if defendants rendered any services to Consensus, is raised by the Government for the first time in this court. In the courts below the Government contended that question was irrelevant. The Government should not be permitted to shift its position.

The Government's theory in the lower courts was that all distributions made by Consensus were distributions of earnings or dividends to stockholders, and that no part was compensation for services rendered. The Government's contention was so understood by the Circuit Court of Appeals (See R. 501). Under this theory, no issue could arise as to the definiteness of the standard of guilt to meet constitutional requirements.

Faced with the holdings of the Court below that the payments were not all dividends and that it had failed to prove the charge in the indictment that defendants had not rendered any services to Consensus, the Government now changes its theory.

It urges (Government Brief p. 22) that the case involves the question as to whether convictions may be obtained, if the payments represented in part compensation paid for services which were deductible, if the remaining portion thereof was not. This contention is based upon the view that the Government is not required to prove an evasion of all the tax charged, but only of a substantial part. Yet no attempt was made by the Government upon the trial to show all of the services performed for Consensus by defendants or the value of their services.

In the Circuit Court of Appeals the Government in its brief urged:

> "First the defendants contend that the alleged commissions representing the distributions of seventy per cent of the company's net profits were deductible expense and they cite the section of the revenue acts which allows deductions for necessary and proper expenses. It is submitted that (1) the question here is not one of the deductibility of commissions paid out by a corporation in the operation of its business but whether these payments of net earnings were 'commissions' " (p. 75).
>
> * * * * *
>
> "On the basis of the foregoing, it is respectfully submitted that there is no issue involved in this case regarding the question of whether commissions may be deducted or whether the payments were reasonable. We cannot repeat too often that there are no questions concerning commissions, because these payments were dividends and were known to be such by the defendants. *Likewise it is wholly irrelevant to discuss the question of whether it would be a violation of the Fifth and Sixth Amendments if individuals were convicted of a crime of deducting unreasonable commissions*" (pp. 82, 83). (Italics supplied.)

The same theory was also advanced by the Government in the trial court. (See argument on motion for a directed verdict. R. 459.)

The argument of the Government in the Circuit Court of Appeals is thus stated in the opinion below (R. 502):

> "The Government in its brief and in oral argument before this Court asserts that the deductions in question must be treated either as dividends in their entirety, and if so as unlawful deductions, or as commissions in their entirety, and therefore properly deducted. In other words, in accordance with this argument there can be no middle ground."

After the opinion of the Circuit Court of Appeals was rendered, the Government, on page 13 of its petition for rehearing, adhered to its position on this question, saying:

> "Again, it must be emphasized that the indictment in the case at bar does not charge that the defendants willfully attempted to evade and defeat taxes by taking deductions of *unreasonable amounts* as commissions, that is, payment for services; rather it charges that the defendants willfully attempted to evade and defeat taxes by claiming as deductions for commissions, amounts which were in fact distributed as dividends and were not intended as compensation for services." (Italics supplied.)

If it was intended by the Government to raise the question as to whether there could be a conviction if only a portion of the commissions paid were not deductible, on the theory that such commissions were in excess of reasonable compensation for services rendered, it would have been essential for the Government to prove all the services rendered by the defendants for Consensus and the reasonable value thereof. But, as stated by the Circuit Court of Ap-

peals: "There was no proof and no effort by the Government to show that the services disclosed constituted the total of those performed and no effort to show the reasonable value of such services" (R. 500).

Indeed, the statement on page 82 of the Government's brief in the Circuit Court of Appeals, "that there is no issue involved in this case regarding" * * * "whether the payments were reasonable", demonstrates the correctness of the conclusion of the Circuit Court of Appeals that the deductions in question under the Government's theory must be treated as dividends in their entirety or as commissions in their entirety. We cannot believe that the Government intends to argue that the jury had the right to speculate, without any evidence on the subject, as to what portions of the sums paid to the defendants were paid as compensation for services and what portions were paid to them as distributions of profits in consequence of their alleged stock holdings.

The question arising under the Fifth and Sixth Amendments to the Constitution, stated in the above quoted excerpt from the Government's brief below, as being wholly irrelevant, is the question now urged by it as the principal question in the case. Yet it refused to discuss that question before the Circuit Court of Appeals and ignored *United States* v. *Cohen Grocery Co.* 255 U. S. 81, and cases of similar import, which had been cited and referred to by respondents, thus depriving the Court below of the assistance of the Government's views upon that question.

The question was raised in the briefs filed by respondents in the Court below, but was removed from the case by the position taken by the Government in its brief.

It is true that the Court below held that there was not a sufficiently definite standard of guilt to meet constitutional requirements as one of the alternative grounds for its de-

cision that the case should not have been submitted to the jury. But when it held, in accordance with the Government's contention, that there could be no middle ground, because the indictment charged that none of the defendants had rendered services (R. 502) and that no evidence as to the total of the services performed or as to the reasonable value thereof had been introduced (R. 500) there was no necessity to consider the constitutional question. The decision on that question was not necessary to support the Court's conclusion. The Court had accepted one of the alternatives presented by the Government. Its acceptance thereof removed the essential premise upon which the constitutional argument had been based,—that if reasonableness of the compensation paid for the services performed was the criterion of guilt, a sufficiently definite standard to meet constitutional requirements was not afforded.

In *Helvering* v. *Wood*, 309 U. S. 344, 349, the question arose as to whether there could be raised in this Court on *certiorari*, a question of law not raised in the Circuit Court of Appeals, in a case where reliance upon a specified section of the Revenue Act (which the court held not applicable) was made and reliance upon any other ground had been waived. The Court held that the Commissioner of Internal Revenue should not be allowed "to add here for the first time another string to his bow"; that "to open here for the first time and in face of the express disclaimer an inquiry into the broader field is not only to deprive this Court of the assistance of a decision below but to permit a shift to ground which the taxpayer had every reason to think was abandoned in the earlier stages of this litigation."

The Government now raises the constitutional question in order to sustain a conviction, if any "substantial portion of the payments involved constituted distributions of corporate profits rather than true commissions" (Br. p. 22), although it is clear from its briefs below and from what is

said in the opinion below concerning its oral argument that it there disclaimed any middle ground and elected to stand or fall upon the theory that the payments to defendants were either dividends in their entirety or commissions in their entirety.

To permit such a shift to a ground which the defendants had every reason to think was abandoned in the earlier stages of the litigation, is condemned by the opinion in the *Wood* case.

Particularly should the rule be enforced here, where the contention made, i. e., that there may be a conviction if any part of the tax due has been wilfully evaded, is not founded upon evidence in the record showing the total of the services performed by defendants or the reasonable value of the services performed. Indeed, if the conviction is to be affirmed, it must be upon the theory that the jury, without evidence on the subject, had the right to conjecture that some part of the payments made to the defendants represented a distribution of earnings as dividends and that consequently there was tax evasion.

III.

To permit a conviction to rest upon the determination by a jury of the reasonableness of the compensation paid for services rendered, without a definite standard for determination of that question, prescribed by statute or regulation, would be contrary to the due process clause of the fifth amendment and the provision of the sixth amendment that in all criminal prosecutions the accused shall enjoy the right to be informed of the nature and cause of the accusation.

Although the prosecution was under Section 145 (b) of the Revenue Act for wilfully attempting to evade income

taxes, and Section 88, Title 18 U. S. C. A., for conspiracy to evade income taxes, the question of whether any tax was attempted to be evaded is dependent upon Section 23 (a) of the Revenue Act, providing that in computing net income, there shall be allowed as deductions "all the ordinary and necessary expenses paid or incurred during the taxable year, including a reasonable allowance for salaries or compensation for personal services actually rendered."

Under the due process clause of the Fifth Amendment and the provision of the Sixth Amendment that the accused shall enjoy the right to be informed of the nature of the accusation against him, all crimes are required to be specifically defined, so that one may know in advance whether an act is within or without the interdiction of the law. The question of guilt or innocence cannot be left to the whims or fancies of triers of the facts, without definite ascertainable standards to guide them. Leaving to the triers of fact the question of guilt or innocence, depending upon their determination of the reasonableness or unreasonableness of the amount of compensation paid for services rendered is violative of the foregoing Amendments of the Constitution. *U. S.* v. *Cohen Grocery Co.*, 255 U. S. 81, 89; *Connally* v. *General Construction Co.*, 269 U. S. 385, 391; *Collins* v. *Kentucky*, 234 U. S. 634, 638; *International Harvester Co.* v. *Kentucky*, 234 U. S. 216, 221; *American Machine Co.* v. *Kentucky*, 236 U. S. 660, 661; *U. S.* v. *Pennsylvania Railroad Co.*, 242 U. S. 208, 237; *Smith* v. *Cahoon*, 283 U. S. 553, 564; *Small Co.* v. *American Refining Co.*, 267 U. S. 233, 238; *Champlain Refining Co.* v. *Commission*, 286 U. S. 210, 242; *Herndon* v. *Lowry*, 301 U. S. 242, 262-264; *Lanzetta* v. *New Jersey*, 306 U. S. 451, 453.

The Treasury Regulation [6] on the subject of deductibility of items paid for services is no more adequate than the statute in fixing a standard.

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[6] This Regulation is set forth in the appendix to this brief.

In *United States* v. *Cohen Grocery Co.*, 255 U. S. 81, the Court considered the constitutionality of the Lever Act, the material provisions of which are contained in the below quoted excerpt from the opinion. The Court held the Act unconstitutional, because it afforded no ascertainable standard of guilt, in that the words, "unjust" and "unreasonable" were inadequate to inform persons accused of the nature and cause of the accusations against them. The Court said, at page 89:

> "The sole remaining inquiry, therefore, is the certainty or uncertainty of the text in question; that is, whether the words, 'that it is hereby made unlawful for any person *wilfully* * * * to make any unjust or unreasonable rate or charge in handling or dealing in or with any necessaries,' constituted a fixing by Congress of an ascertainable standard of guilt, and are adequate to inform persons accused of violation thereof of the nature and cause of the accusation against them. That they are not, we are of opinion so clearly results from their mere statement as to render elaboration on the subject wholly unnecessary. Observe that the section forbids no specific or definite act. It confines the subject-matter of the investigation which it authorizes to no element essentially inhering in the transaction as to which it provides. It leaves open, therefore, the widest conceivable inquiry, the scope of which no one can foresee, and the result of which no one can foreshadow or adequately guard against. In fact, we see no reason to doubt the soundness of the observation of the court below in its opinion to the effect that, to attempt to enforce the section would be the exact equivalent of an effort to carry out a statute which in terms merely penalized and punished all acts detrimental to the public interest when unjust and unreasonable in the estimation of the court and jury." (Italics supplied.)

The Government seeks to distinguish the *Cohen Grocery Co.* case on the ground that the statute here requires that there be a *wilful* attempt at tax evasion. But in the *Cohen* case also the statute required the prohibited action to be wilful and the statute was so interpreted by the Court. (See statute as quoted at 255 U. S. 89.)

The standard of guilt furnished by the Revenue Act, i. e. "a reasonable allowance for salaries or other compensation for personal services actually rendered" is no more definite or certain than that fixed by the statute held invalid in the *Cohen* case.

As illustrative of the conflicting results likely to be obtained if the question of the propriety of the taking of a deduction for compensation payable upon a percentage basis may be left to the judgment of the triers of the facts, dependent upon their view of the reasonableness or unreasonableness of the amount of the compensation, we point to the jury verdict in this case, and ask that it be compared with the results in civil cases where like questions were under consideration.[7]

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[7] In *Wm. S. Gray & Co.* v. *United States*, 35 F. (2d) 968, (Court of Claims), commissions in addition to fixed salaries of a substantial sum were paid by a corporation to certain executives and directors, who also owned 88% of the stock, amounting to all of the corporation's earnings after a 7% dividend on its stock. The corporation's income after taxes and expenses (exclusive of compensation to executives and directors) and the amounts paid as commissions and fixed salaries were:

	Income	*Fixed Salaries*	*Commissions*
1916	$507,786.00	$25,800.00	$430,000.00
1917	488,941.00	53,750.00	196,145.00
1918	296,173.00	80,000.00	73,500.00

The sums paid for compensation for services were held properly deductible.

In *Austin* v. *U. S.*, 28 F. (2d) 677 (C. C. A. 5) sums paid to the three officers of a company under a contract to pay each officer one-third of its net profits were held properly deductible. In one year the sum paid to the officers was approximately $168,000.00.

The *Gorin* case, 312 U. S. 19, principally relied upon by the Government, refers to the *Cohen Grocery Co.* case with approval. In the *Gorin* case the statute involved prohibited obtaining and delivering documents "connected with the national defense" with "intent or reason to believe that the information to be obtained is to be used to the injury of the United States, or to the advantage of any foreign power." The court held that the sanctions of the statute applied only when the specific scienter required by the statute was established and that "the use of the words 'national defense' has given them as here employed, a well understood connotation." The Court defined the term "national defense," as meaning " 'a generic concept of broad connotations, referring to the military and naval establishments and the related activities of national preparedness.' " It held that the words "national defense," as used in the Act, carried the meaning so defined, and that therefore the language employed "appears sufficiently definite to apprise the public of prohibited activities and is consonant with due process."

In the case of Section 23(a) of the Revenue Act, as stated by the Court in *William S. Gray & Co.* v. *United States*, 35 F. (2d) 968, 973, "there is no fixed and unalterable standard or yardstick by which the question of the reasonableness of the compensation in any particular case can be measured." The determination of the standard depends upon the judgment of the triers of the facts.

The two cases (the *Gorin* and *Cohen Grocery Co.* cases) are but two of the many cases decided by this court determining on which side of the line falls a statute, the constitutionality of which is challenged on the ground that it does not provide a sufficiently definite standard of guilt. The *Gorin* case refers both to criminal statutes which were held to be too vague and thus to fall on one side of the line, and to other criminal statutes held to define a crime ade-

quately and thus to fall on the other side of the line. We submit the statute in this case, if construed as the Government seeks to have it construed, is within the former category, and that it is closer to the statute held unconstitutional in the *Cohen Grocery Co.* case than the statute involved in any case cited by the Government.

The factors involved in the process of differentiating statutes which do not furnish a sufficiently definite standard to meet constitutional requirements from those which do have been explained by the court in *Connally* v. *General Construction Co.*, 269 U. S. 385, 391. The court there considered the constitutionality of a statute requiring a contractor to pay his employees "not less than the current rate of per diem wages in the locality where the work is performed." Denying that the statute contained an ascertainable standard of guilt, the court said (p. 391):

> "The question whether given legislative enactments have been thus wanting in certainty has frequently been before this court. In some of the cases the statutes involved were upheld; in others, declared invalid. The precise point of differentiation in some instances is not easy of statement. But it will be enough for present purposes to say generally that the decisions of the court upholding statutes as sufficiently certain rested upon the conclusion that they employed words or phrases having a technical or other special meaning, well enough known to enable those within their reach to correctly apply them. *Hygrade Provisions Co.* v. *Sherman*, 266 U. S. 497, 502, 69 L. Ed. 402, 407, 45 Sup. Ct. Rep. 141; *Omaechevarria* v. *Idaho*, 246 U. S. 343, 348, 62 L. ed. 763, 767, 38 Sup. Ct. Rep. 323, or a well-settled common law meaning, notwithstanding an element of degree in the definition as to which estimates might differ. *Nash* v. *United States*, 229 U. S. 373, 376, 57 L. ed. 1232, 1235, 33 Sup. Ct. Rep. 780, *International Harvester Co.* v. *Kentucky*, *supra*, p. 223, (58 L. ed.

1288, 34 Sup. Ct. Rep. 853), or, as broadly stated by Mr. Chief Justice White in *United States* v. *L. Cohen Grocery Co.*, 255 U. S. 81, 92, 65 L. ed. 516, 522, 14 A. L. R. 1045, 41 Sup. Ct. Rep. 298, 'that, for reasons found to result either from the text of the statutes involved or the subjects with which they dealt, a standard of some sort was afforded.' See also *Waters-Pierce Oil Co.* v. *Texas*, 212 U. S. 86, 108, 53 L. ed. 417, 429, 29 Sup. Ct. Rep. 220. Illustrative cases on the other hand are *International Harvester Co.* v. *Kentucky*; *Collins* v. *Kentucky*; and *United States* v. *L. Cohen Grocery Co.*—*supra*, and cases there cited."

This opinion, it should be observed, treats *Omaechevarria* v. *Idaho*, 246 U. S. 343, 348, and *Hygrade Provision Co.* v. *Sherman*, 266 U. S. 497, 501, relied on by the Government to support the proposition that a statute cannot be attacked for vagueness where intent is required, as holding a statute is not vague where the words used have "a technical or other special meaning, well enough known to enable those within their reach to correctly apply them." No such element is present in this case. No well settled common law meaning, as in the homicide or restraint of trade cases, is present here. Nor is there, it is submitted, a standard of any sort contained in the text of the statute or the subject with which it deals.

On page 28 of its brief, the Government contends that Section 145 (b) prescribes its own standard and defines the crime charged, and complains that the court below disregarded that standard and seized upon the civil provisions of Section 23 (a), permitting deduction of reasonable business expenses, and, in effect, viewed the prosecution as based upon the latter section.

Under Section 145 (b) there must be an attempt at tax evasion. The question of tax evasion must be determined from a consideration of the applicable provisions of the Revenue Act, which in this case is Section 23 (a).

On page 30 of the Government's brief it is stated: "That men may differ on matters of judgment should afford no protection to those who wilfully make false returns." But here the question as to whether the return is false or not depends upon a matter of judgment. Here, if the statute is to be construed as the Government contends it should be, whether there is tax evasion or not depends upon the judgment of the triers of the fact as to the reasonableness of the compensation paid without any sufficiently definite standard laid down by the statute or regulations for determining that question.

The question here is not whether the Government is required to prove an evasion of all the tax charged, but whether it must prove an actual evasion of some part of the tax, the determination of which can be made by reference to a standard sufficiently definite to meet constitutional requirements.

The sufficiency of the statutes here involved to define an adequate standard of guilt was not raised or discussed in *Tinkoff* v. *United States*, 86 F. (2d) 868; *United States* v. *Kelley*, 105 F. (2d) 912; *United States* v. *Zimmerman*, 108 F. (2d) 370, or *Wagner* v. *United States*, 118 F. (2d) 801. Those cases involved the deduction of bad debts which were fictitious. The *Kelley* and *Wagner* cases also involved deductions for depreciation based on fabricated costs.

We submit that the trial court erred in instructing the jury in the manner set forth on pages 13 and 14 of the Government's brief[8], because it thus left to the jury the

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[8] In addition to the portions of the charge to the jury set forth in the excerpts in the Government's brief, the following portion of the charge is material:

> "It is your duty to consider all the evidence in the case, including the circumstances, and from those, and considering nothing outside of the evidence presented to you, you must answer eventually the question of whether these sums distributed, or a substantial part thereof, actually represented profits, distribution of profits, rather than the payment of compensation" (R. 471).

question of guilt, depending upon the jury's finding as to the reasonableness of the compensation paid, without any sufficiently ascertainable standard for determining that question. This question was also raised by and argued on the motion for a directed verdict and on objections during the trial (R. 232; 432).

IV.

The Government failed to prove the charge made in the indictment. Error in the charge to the jury. The sufficiency of the exception to the charge.

The Government contends that the fifth count does not allege that no services had been performed, that it merely alleges that such services had not been performed by virtue of the so-called employment contracts (Gov. Br. 31).

We have already answered this argument (pp. 27-30 of this brief). We have also there answered the argument that the Government, in the courts below, did not contend that the deductions must be either wholly dividends or wholly commissions, as held by the Circuit Court of Appeals (R. 502). Indeed, in the absence of evidence as to the total of the services performed and the reasonable value thereof, there was no foundation upon which to base any other contention. The Government failed to prove the charge contained in the indictment on this subject.

The portion of the charge of the Court excepted to was properly held to be erroneous by the Circuit Court of Appeals because it was inconsistent with the indictment and the theory upon which the case was tried, and also because it left the jury at liberty to speculate and conjecture, without any basis in the evidence, as to what portion of the items paid was compensation for services and what portion was dividends.

The question involved is not one as to whether the Government is required to prove the entire amount of the tax charged to have been evaded. It is whether the Government is required to prove the charge alleged in the indictment, and to prove by competent evidence that there was a tax evaded or attempted to be evaded. The misleading and erroneous character of the portion of the charge excepted to is not obviated by any such hypotheses as are stated on pages 34 and 35 of the Government's brief. The criticized portion of the charge could only have been understood by the jury as authorizing them to determine whether any substantial portion of the amounts paid was a distribution of profits rather than the payment of compensation, thus leaving them at liberty to determine whether the amounts paid were excessive for the services performed, and if they so determined (although they could so determine only upon conjecture and not upon any evidence in the case), to return a guilty verdict.

The Government challenges the sufficiency of the exception taken to the criticized portion of the charge (Gov. Br. 34). The argument on the necessity of a definite standard of guilt was urged at length during the trial and on the motion for a directed verdict (R. 432, 458). The trial court was not in any doubt as to the question intended to be raised by the exception to the charge. The exception was sufficient.

However, "in criminal cases courts are not as inclined to be exacting with reference to the specific character of the objections made, as in civil cases." *Crawford* v. *United States*, 212 U. S. 183, 194. Indeed, reviewing courts in criminal cases may notice error occurring in the trial of a criminal case, although the question was not properly raised at the time by objection or exception. *Crawford* v. *United States*, 212 U. S. 183, 194; *Wiborg* v. *United States*, 163 U. S. 632, 658; *Weems* v. *United States*, 217

U. S. 349, 362. The Circuit Court of Appeals could have considered the questioned instruction even if no objection, exception or assignment of error had been taken thereto. *Lamento* v. *United States*, (C. C. A. 8) 4 F. (2d) 901, 904; *Meadows* v. *United States*, (Ct. App. D. C.) 82 F. (2d) 881, 884.

CONCLUSION.

It is respectfully submitted that the judgment of the Circuit Court of Appeals was correct and should be affirmed.

Respectfully submitted,

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APPENDIX.

Article 126, Regulations 74, issued under the Revenue Act of 1928:

ART. 126. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former

partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

Article 126 is identical with Article 126 of Regulations 74.

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Article 23(a)-6 is identical with Article 126 of Treasury Regulations 77 above quoted, except that in sub-

section 3 the words "under all the circumstances" are used instead of the words "in all the circumstances" and the words "under like circumstances" are used instead of the words "in like circumstances."

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Article 23(a)-6 is identical with Article 23(a)-6 of Treasury Regulations 86.